

*United States Court of Appeals
for the Second Circuit*



**APPELLANT'S
BRIEF**

76-4020

UNITED STATES COURT OF APPEALS

FOR THE
SECOND CIRCUIT

W. Lee Knight and Evelyn Knight,
Petitioners - Appellants

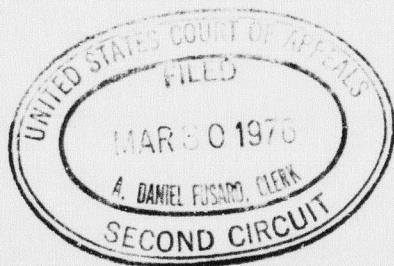
v.

Docket No. 76-4020

Commissioner of Internal Revenue,
Respondent - Appellee

APPEAL - TAX COURT DECISION
BRIEF FOR PETITIONERS - APPELLANTS

B
P/s



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LIST OF CITATIONS

American - LaFrance - Foamite Corporation v. Commissioner,
284 F. 2d 723 (2nd Cir. 1960).

S. E. Maitland Brenhouse, 37 T. C. 326 (1961).

George Butler, 36 T. C. 1097A (1961)

B. A. Faucher, T. C. Memo 1970-217 (1970).

A. H. Kelson, Civil No. C-293-71 (D. Utah, Filed June 29, 1973).

Curtis W. Kingbay, 46 T. C. 147 (1964).

Hubert M. Luna, 42 T. C. 1067 (1964).

Ida Rosati, T. C. Memo 1970-343 (1970).

A. L. Stanchfield, T. C. Memo 1965-305 (1965).

Trent v. Commissioner, 291 F. 2d 669 (2d Cir. 1961).

U. S. v. Generes, 405 U. S. 93 (1972).

Dwight A. Ward, 20 T. C. 332, 343 (1953), aff'd 224 F. 2d 547 (9th Cir. 1955).

Whipple v. Commissioner, 373 U.S. 193, 202 (1963).

STATUTES AND REGULATIONS INVOLVED

Section: 166. Bad Debt

(a) General Rule.

(1) Wholly worthless debts. There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially worthless debts. When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) Amount of Deduction.

For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property. ---

(d) Nonbusiness Debts. ---

- (2) Nonbusiness debt defined. For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than-
- (a) A debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or
 - (b) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

Section: 761 Term defined.

- (a) Partnership.--- For purposes of this subtitle, the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate.

Regulation: § 1.166-5 (b) Nonbusiness Debts.

- (b) Nonbusiness Debt Defined. For purposes of section 166 and this section, a nonbusiness debt is any debt other than ---
- (1) A debt which is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or

(2) A debt, the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The question whether a debt is a non-business debt is a question of fact in each particular case.

STATEMENT OF ISSUES

PRESENTED FOR REVIEW

Did the Tax Court err in determining that the debt in controversy did not bear the necessary relationship to any trade or business conducted by the Petitioners and that it therefore should be classified as a non-business debt?

STATEMENT OF THE NATURE OF THE CASE

The case involves a deficiency in income tax for the calendar year 1968 in the amount of \$8,906.81.

Petitioners and the DeMattos made loans to Dak Company, Inc.,

a corporation they had incorporated and in which they were sole shareholders. In 1968, Dak Company, Inc. had outstanding loans of \$36,641.38 payable to its shareholders, one-half to which were payable to Petitioners. Petitioners incurred a bad debt in the amount of \$18,320.69 in 1968. Respondent contends that the bad debt is a nonbusiness bad debt and there is a tax deficiency for the year 1968 in the amount of \$8,906.81.

Petitioners contend that the bad debt is a business bad debt and is deductible in full in 1968.

The case was heard before Hon. Arnold Raum in New York; a decision was entered in favor of the Respondent. Petitioners appeal this decision.

CONCISE STATEMENT OF FACTS

1. On December 12, 1956, petitioners W. Lee Knight, Evelyn W. Knight, and two other individuals, Jacques DeMattos and Jeanne DeMattos contracted to purchase certain property known as the Holiday Motel and Holiday Restaurant (hereinafter referred to as the premises). The Agreement for Deed is marked Joint Exhibit 2-B.

2. A memorandum setting forth various transactions with regard to the premises is Joint Exhibit 3-C.

3. A Registration of Fictitious names dated February 8, 1957, is Joint Exhibit 4-D.

4. A certificate of incorporation of Dak Company, Inc. was filed in the office of the Secretary of State of the State of Florida on April 26, 1957.

5. The capital stock of Dak Company, Inc. consisted of 100

shares of common stock, 50 shares of which were issued to petitioners in exchange for cash of \$17,500.00 and 50 shares of which were issued to Mr. and Mrs. Jacques DeMattos in exchange for cash of \$17,500.00. There were no transfers of stock or any further issuance of stock of Dak Company, Inc. from the time of its incorporation until the time of its dissolution in October 1969.

6. Petitioners and DeMattos and Dak Company, Inc. in substance became a partnership.

7. The Minutes of the Board of Directors of Dak Company, Inc. dated February 13, 1958, are marked Joint Exhibit 22-v.

8. Dak Company, Inc. had outstanding loans payable to its shareholders, one-half of which loans were payable to petitioners, as follows:

<u>Year</u>	<u>Loan</u>	<u>Repayment</u>	<u>Balance as of December 31</u>
1957	\$40,000.00	\$18,896.00	\$21,104.00
1958	12,147.24	221.37	33,029.87
1959	---	---	33,029.87
1960	---	---	33,029.87
1961	---	---	33,029.87
1962	---	---	33,029.87
1963	---	---	33,029.87
1964	2,900.00	---	35,929.87
1965	---	800.00	35,129.87
1966	---	200.00	34,929.87
1967	2,211.51	---	37,141.38
1968	---	500.00	36,641.38

9. Petitioners incurred a bad debt in the amount of \$18,320.69 in 1968.

10. Dak Company, Inc. was dissolved on October 14, 1969, with the filing of a certificate of corporate dissolution with the Secretary of State of Florida.

ARGUMENT

The only issue presented is whether or not the bad debt of \$18,320.69 incurred in 1968 is a business bad debt. Petitioners contend that it is. As a result, the debt was deductible in full in the year that it arose.

The Internal Revenue Code defines a business bad debt as:

- (A) A debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or
 - (B) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business. § 166
- (d) (2)

The Treasury Regulations state that it is a "question of fact" whether a debt is a business or nonbusiness debt. § 1.166-5 (b).

The record clearly shows that petitioners, W. Lee Knight and Evelyn W. Knight together with two other individuals and Dak Company, Inc. incurred the debt in connection with a trade or business, thus creating a business bad debt. Petitioners relied on two arguments to demonstrate their trade or business in the Tax Court: (1) a partnership loan is a business loan, the loss of which is a business bad debt and (2) petitioners were employees and officers of the corporation, whose dominant motivation in making loans was related to their business.

PARTNERSHIP LOAN / BUSINESS BAD DEBT

The four individuals together with Dak Company, Inc. were coventurers or partners. Partnership is defined by the Internal Revenue Code as follows:

The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of the title, a trust or estate or a corporation.

§ 761

The mere fact that one of the members of a partnership is a corporation does not nullify the entity from being a partnership. Beck Chemical Equipment Corporation, 27 T. C. 840 (1957). Even a corporation wholly owned by one of the other partners can be a partner. Charles Turner, T.C. Memo 1965-101 (1965); Maggio Bros. Co., Inc. 6 T. C. 999 (1946). A partner is engaged in the business of the partnership. Dwight A. Ward, 20 T. C. 332, 343 (1953), aff'd. 224 F. 2d 547 (9th Cir. 1955). A partner's loan to his partnership is a business loan even though the partnership is not the taxpayers only or principal business. George Butler, 36 T. C. 1097A (1961); S. E. Maitland Brenhouse, 37 T. C. 326 (1961).

The stipulated facts demonstrate that the Knights and the DeMattos intended and were, in fact, coventurers with Dak Company, Inc. A joint venture depends on the intent of the parties. Intent is a question of fact, Hubert M. Luna, 42 T. C. 1067 (1964). The stipulated facts clearly demonstrate that the Knights, the DeMattos and Dak Company, Inc. intended to engage in and did engage in a joint venture or partnership.

The purchase, the mortgages, and the sale demonstrate that the owners of the Holiday Motel and Holiday Restaurant were the individuals. In December 1956, the petitioners, W. Lee Knight and Evelyn Knight and two other individuals, Jacques DeMattos and Jeanne DeMattos purchased the Holiday Motel and Holiday Restaurant. The same four individuals mortgaged the premises in 1957 to the McKinnons; such mortgage referred to the promissory note from the Knights to the McKinnons. The owners of the Holiday Motel and Holiday Restaurant, the Knights and the DeMattos mortgaged the premises and personal property in 1964 to the State Exchange Bank of Lake City, and the McKinnons that same day gave a satisfaction of their mortgage to the four individuals. The motel and restaurant were eventually sold by the Knights and the DeMattos to the Summers in 1968. As the search of the Columbia County records shows, Dak Company, Inc. was never the grantee of the premises known as the Holiday Motel and Restaurant. (Joint Exhibit 3-C)

An original form of partnership agreement was filed in 1957 in Columbia County, Florida in the form of a Registration of Fictitious Names. (Jt. Ex. 4-D) That document states that the Knights and the DeMattos were all the persons interested in and carrying on the business under the name of the Holiday Motel and Holiday Restaurant.

Dak Company, Inc. was formed in 1957; its function was to conduct the business of the motel and restaurant, in such a fashion as to retire the indebtedness, for which the individuals were responsible. Petitioners and the DeMattos were incorporators,

officers and directors of the corporation. Dak Company, Inc. operated the motel and restaurant business from 1957 to 1968. Substantively then, it was responsible for meeting the mortgage payments for which the individuals were liable. Legal title remained in the individuals, the premises were mortgaged in their names and Dak Company, Inc. was to operate the business in such a fashion as to retire the indebtedness. The loans were made by the petitioners and the DeMattos to the corporate entity which conducted the business; these loans are stipulated as 1968 bad debts. It is one half of these loans that petitioners claim is a business bad debt.

The tax consequences of a transaction are governed by substance not form. American - LaFrance - Foamite Corporation v. Commissioner, 284 F 2d 723 (2d Cir. 1960). The Tax Court listed the following factors as relevant to the issue of whether or not a joint venture exists.

The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed

Federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise. Hubert M. Luna, 42 T. C. 1067, 1077-1078 (1964).

However, the Tax Court has found a joint venture in case where most of the "Luna" factors were lacking, A. L. Stanchfield, T. C. Memo 1965-305 (1965). Stanchfield was approached by his son-in-law, president of Peterson Construction Company, Inc. for advances to meet corporate obligations; it being understood, although not written, that the petitioner would be entitled to share the profits derived from two construction contracts. Initially, Peterson suggested a partnership and Stanchfield was unwilling to participate on that basis. From October 1958 through July 1959 Stanchfield advanced \$71,000.00 to Peterson and Peterson Construction Company, Inc. The fact that the loans of \$20,000 were made to Peterson and \$51,000 were made to Peterson Construction Company, Inc. were not considered significant in that the loans were "advances into the job", i.e. the performance of two contracts for Gulf States Utilities Company. A. L. Stanchfield, Incorporated made advances of at least \$30,000 to Peterson Construction Company, Inc. for the same reason. Interest bearing notes were given in return for these advances; as of the time of trial none of these notes had been paid. Stanchfield had only a limited right of withdrawal -- he and Peterson could sign the checks on a special account which

was opened in July of 1959 after Stanchfield had already advanced \$66,000. All progress payments on the contracts were made to Peterson Construction Company, Inc. and all funds were dispersed solely by Peterson. Stanchfield had no employees working on either construction contract, he was not in the construction business, nor was he an officer or shareholder of the corporation. Business was not conducted in the name of both parties, nor did Stanchfield hold himself out to third parties as a joint venturer. Nevertheless, the Tax Court found that Stanchfield and Peterson "in good faith and acting with a business purpose intended to join in the present conduct of the enterprise" ¶65,305 P - H Memo T. C. at 1853 and were joint venturers. The court found that the fact that Stanchfield had initially negated an intention of becoming a partner with Peterson was not determinative of whether or not a joint venture existed. Neither were the facts that Stanchfield did not sign contracts, hold himself out as a joint venturer nor actively participate in the business vitiate the existence of a joint venture. The court also stated that filing Federal partnership returns and keeping separate books were not indispensable to the formation of a joint venture. ¶ 65,305 P. H. Memo T. C. 65-1852 and 1853. The business conducted by Peterson and Stanchfield was a trade or business within the meaning of the Code.

Similarly, the business conducted by the Knights, the DeMattos and Dak Company, Inc. was a trade or business within the meaning of the code. Petitioners herein were engaged in

the business of the partnership, i.e. owning and operating the Holiday Motel and Holiday Restaurant. The Knights and two other individuals, as some of the partners, made loans to Dak Company, Inc. which conducted the operation of the motel and restaurant. These loans were made in furtherance of the partnership business in order that the mortgages on the premises for which the individuals were responsible would be discharged. The stipulated facts demonstrate that the loans were made by the petitioners and the DeMattos, and treated by the corporation on its records as loans. These loans became worthless in 1968 and petitioners incurred a bad debt. Its characterization under the law is a business bad debt. The law is clear that a partner is in his partnership's business whether he is an active partner, a general partner, or a limited or special partner. And a ~~partner's~~ loan to his partnership is a business loan even though the partnership is not the taxpayers only or his principal business. Brenhouse, 37 T. C. 326 (1961). Butler, 36 T. C. 1097 (A) (1961). A bad debt which is the result of a business loan is none other than a business bad debt.

DOMINANT MOTIVATION / TRADE OR BUSINESS

Loans by a corporate executive or employee to the corporation employing him are business bad debts if made to preserve his job or salary. Trent v. Commissioner, 291 F. 2d 669 (2d Cir. 1961). In holding that dominant motivation rather than significant motivation determines whether a bad debt is proximately related to a taxpayers business, the Supreme Court in U.S. v. Generes,

405 U.S. 93 (1972) again reaffirmed that a taxpayer can have a business interest in a corporation that is entirely distinct from a shareholder or non business interest. The Court cited with approval the Trent line of cases stating that if the debt was centered in the taxpayer's business interest in the corporation the rewards of which were "centered in personal effort and labor, and salary for that endeavor would be received," 405 U.S. at the taxpayer deserved to prevail.

One of those cases is Ida Rosati, T. C. Memo 1970-343 (1970), where the Tax Court found that employment as a corporate executive constitutes a trade or business. In Rosati, the taxpayer was found to be sufficiently motivated by desire to protect his trade of being president of the corporation to mortgage his home for \$300,000.00 to protect an annual salary of \$26,000.00.

Another memorandum decision cited by the Supreme Court in Generes was B. A. Faucher, T. C. Memo 1970-217 (1970). In Faucher, taxpayers were sole shareholders in a corporation. They loaned the corporation \$2,000.00 and entered the loan on the corporation's books as "Notes - Payable - Other" Even though their accountant later transferred the \$2,000.00 amount to capital stock outstanding, the Tax Court found that the \$2,000.00 was intended to be a loan and a business bad debt, stating that for purposes of § 166d of the Int. Rev. Code of 1954, the activities of president and general manager of a corporation constituted a trade or business, and petitioners had advanced \$2,000.00 to continue employment with the corporation.

Similarly, petitioners' bad debt was incurred in their business. W. Lee Knight and Evelyn W. Knight were 50% shareholders, corporate executives and employees of Dak Company, Inc. The original loan of \$40,000.00 evidenced by a debenture note payable on demand at the stated interest rate of 5% was carried on the corporate balance sheet as "Notes Payable - Stockholders." It was treated as a loan by petitioners and the corporation, as were the other loans made in 1958, 1964, and 1967. Accrued interest on all loans was accumulated on the Dak Company, Inc. balance sheet under "Other Liabilities." Respondent has, in fact, agreed that the monies advanced to the corporation were loans. There is no question but a bad debt was incurred and petitioners are entitled to a bad debt deduction.

The bad debt was incurred in the taxpayers' trade or business. While petitioners as shareholders had a capital interest in Dak Company, Inc., the bad debt was incurred to protect the interest centered in their personal effects and labor as corporate officers and employees. The stipulated facts recite and the joint exhibits show that the officers expected remuneration and did, in fact, receive \$10,000.00 in 1957, one half of which was payable to petitioner W. Lee Knight. Not only were officers' salaries paid, life insurance on the officers was an annual corporate administrative expense. Petitioner was a salaried employee of Dak Company, Inc. He was in the trade or business of rendering services for compensation. His dominant motive in incurring the bad debt was to protect his trade of being president of the corporation and continue

employment so as to enable him to obtain compensation for services -- a business bad debt.

A United States District Court in Utah filed an opinion finding a business bad debt in an analogous situation. Petitioner had purchased a controlling interest in a corporation. He was an employee, president and director of the corporation and received a salary of \$1,750.00 in 1964. At the same time he was an employee of the Bank of Salt Lake, as well as director of Continental Thrift and Loan, for which he received reasonable compensation. In 1964 taxpayer made two loans totalling \$100,000.00 to the corporation. In 1965 and 1966 he received salaries of \$6,000.00 annually from the corporation of which he was president and director as well compensation from other businesses. In 1966 he loaned \$99,440.00 to the corporation. The corporation liquidated its assets in 1967. The court found that taxpayer's dominant purpose and motivation in loaning \$199,440.00 to his corporation was to obtain an executive position with the corporation and its subsidiaries so as to enable him to obtain compensation for personal services. Thus, the indebtedness was created, acquired and became worthless on connection with the taxpayer's trade or business. In reversing, the Tenth Circuit found that the loans were made to protect taxpayer's investment, and only incidentally to protect his salary. A. H. Kelson v. U.S., 34 A.F.T.R. 2d 74-6007 (10th Cir. 1974), rev'd and rem'd Civil No. C-293-71 (D. Utah, Filed 6/29/73). However, Kelson's adjusted basis in the capital stock of his corporation was \$366,000. Petitioners' investment in Dak Company, Inc. was \$17,500., the salary was

\$5,000., and the loans for which a business bad debt is claimed total \$18,320.69. Petitioners contend that the reason for the Tenth Circuit reversal, i.e. the disparity between the loans and salaries would not be applicable to the facts in their case. For such a disparity does not exist. Clearly the end result in petitioners' case would be different from that found by the Tenth Circuit in Kelson.

Petitioners were both officers and employees of Dak Company, Inc. These activities constituted a trade or business. Their interest, then, was not capital in nature, but rather an interest "centered in personal effort and labor." Generes, 405 U.S. at , a business interest. The loans which resulted in a bad debt were created in order to protect and preserve this business interest.

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PROOF
OF
SERVICE

STATE OF NEW YORK)
) SS.:
COUNTY OF ESSEX)

MARGARET DORAN being duly sworn, deposes and says; that deponent is not a party to this action, is over 18 years of age and resides at Lake Placid.

On the 26th day of March, 1976 deponent served three copies of petitioners brief by mail, addressed to respondent at U.S. Dept. of Justice, Washington, D.C. by depositing same enclosed in a postpaid properly addressed wrapper, in -- a post office -- under the exclusive care and custody of the United States post office department within New York State.

Margaret Doran

Sworn to before me this 26th day of March, 1976.

Henry J. Yellus
Notary Public
State of N.Y.
C.E. 3-30-77

CONCLUSION

For a debt to be a business bad debt, and be deductible in its entirety in the year it arose, it must be incurred in connection with the taxpayer's trade or business. The record clearly shows that petitioners, the DeMattos and Dak Company, Inc. were engage in a joint venture or partnership. Loans made in furtherance of the partnership business are business loans. There is also evidence to show that petitioners as officers and employees of Dak Company, Inc. were engaged in a business activity and the loans were made to protect this activity. Under either or both theories, the loans were incurred in the taxpayers' trade or business and are, therefore, a business bad debt. As a business debt, the \$18,320.69 was deductible in full in 1968.

The tax Court's Decision that the debt did not bear the necessary relationship to any trade or business conducted by petitioners, and it must be classified as a nonbusiness debt should be reversed.

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